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UNCLAS SECTION 01 OF 03 BRASILIA 001239

SIPDIS

SENSITIVE

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STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
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DOE FOR SLADISLAW

E.O. 12958: N/A
TAGS: ENRG EINV ECON PGOV BR
SUBJECT: BRAZIL: LATEST ENERGY AUCTION FURTHER REDUCES
CREDIBILITY OF NEW MODEL

REFS: A) BRASILIA 0040

B) SAO PAULO 0134
C) 03 BRASILIA 3942

¶1. (SBU) SUMMARY. On April 2, Brazil held its second auction of long-term contracts to supply electric energy under its new energy model. The Minister of Mines and Energy once again hailed the auction of energy to be delivered beginning in 2008 and 2009 as a success because the prices represented what it believes to be a fair value for the energy, but were still low for consumers. However, contracts representing only 42% of the energy demand offered in this round were auctioned, and no energy contracts beginning in 2009 were signed, although some of the demand for these years had already been met with contracts sold in the December 2004 auction. Many industry analysts and energy producers consider the auction a failure and complained about the lack of transparency of the process and rules which appear to artificially depress prices. Although the upcoming auction for "new" energy projects is considered to be the real test of the Lula administration's energy model, unless the GOB reconsiders its auction rules and objectives, the April 2 event will cast a cloud over the investment climate in the electricity sector. END SUMMARY.

AUCTION RESULTS

¶2. (U) The new energy model was one of the Lula administration's early priorities (Ref C), and the April 2 auction constituted the second round of electric energy auctioned under this new model. (Ref A reports on the first auction.) The April 2 auction included two "products," each of which was an eight-year contract to supply electric energy beginning in 2008 and 2009. In total, only 42% of the energy demand placed up for auction was sold (1,325 megawatts) for R$7.7 billion (US$3.1 billion). (Note: Because the contracts are for eight years, some of the contracts signed during the previous auction will meet demand anticipated for these same years. End Note.) The average price for contracts beginning in 2008 was R$83.13 MWh (US$33.25), and no energy for contracts beginning in 2009 was sold.

¶3. (SBU) Mauricio Tolmasquim, then Executive Secretary (vice-minister) of the Ministry of Mines and Energy (MME), told Brasilia EconOffs on April 13 that the goal of the auction was to achieve "adequate prices." (On April 29, Tolmasquim became the President of the GOB Energy Research Enterprise (EPE). The new Executive Secretary is Nelson Huber.) Tolmasquim considered the results "good" because the prices matched econometric expectations of a reasonable rate of price increases. In terms of contracted energy, Tolmasquim said the glass should be seen as half-full, and claimed that Peru and Chile were interested in Brazil's energy model. In those terms, the auction was the success that the MME has claimed: prices across the two auctions were R$57.71 MWh for 2005, R$67.33 MWh for 2006, R$75.46 MWh for 2007, and R$83.13 MWh for 2008 -- a smooth curve when graphed. Given the limited amounts sold in this round, however, the auction itself just barely avoided a total collapse and the president of the Brazilian Chamber of Electric Energy Investors (CBIEE) is quoted in the press as calling the auction results "disastrous."

¶4. (SBU) Tolmasquim told Emboffs that the GoB would have to hold new auctions for the unmet 2008 and 2009 demand. Implicitly acknowledging that the auction rules and structures had been complex, Tomasquim said that a new auction would be simple, focused on meeting demand beginning in a single year. He also noted that the "new" energy auction, planned for June or July, would likely have to be postponed until these additional "old" energy auctions could be completed. (Note: the MME distinguishes between "old" energy -- from generators that came on-line before January 1, 2000 --, and "new" energy -- from future generators and those that came on-line after January 1, 2000. End Note.)

AUCTION RULES: THROUGH A GLASS DARKLY...

¶5. (SBU) According to several of our interlocutors, aspects of the auction have lead to suspicions of excessive government intervention in the process. For instance, the MME made last minute changes to the auction rules, including a decision to decrease the demand to be sold by the 700 MW that had not been purchased in the December 2004 auction and was held over for the April 2 event. Executive Director Regis Martins of the Brazilian Association of Independent Electric Energy Producers (APINE) said that this last minute change provoked such an outcry by producers and distributors that on April 1, the MME reinserted the 700 MW into the demand to be auctioned.

MANIPULATION OF DEMAND

¶6. (SBU) Echoing concerns first voiced following the December 2004 auction, personnel in the National Electric Energy Regulatory Agency (ANEEL), APINE, representatives of large energy generation companies, and energy analysts all told us that the auction rules artificially cut the demand during the bidding process. This has the effect of forcing prices down. Christiano Vieira da Silva, an advisor in ANEEL's Economic Market Studies division, told Brasilia EconOff that a slice of the demand was "cut" off the top so that the auction would not be aborted because of insufficient supply. With the demand set as lower than the supply, the auction system continued to drop the price. In the end, however, the auction prices were considered too low by so many suppliers that they withdrew their offers, forcing MME to remove the 2009 contracts from the auction altogether. A JP Morgan analyst reported that the decision to cancel the offer for contracts beginning in 2009 "underscored the complexity of the auction rules, and the [energy] pool's vulnerability to alleged government interference over prices."

INDUSTRY GRADE? "F" FOR FAILURE

¶7. (SBU) The industry response to the first auction in December 2004 was mixed, but with some significant positive sentiment (Refs A and B); however, the reaction to this second round auction was generally negative. APINE considers the auction a failure. On the Sao Paulo stock market (BOVEPSA) the Monday following the auction, 6 of the 10 stocks with greatest loss of value on were in the electric energy sector. In a meeting with Brasilia and Rio EconOffs, Pactual Investment Analyst Pedro Batista said he had expected to see more "rational" results in the second auction because of tighter supply/demand, more involvement of non-state producers, less concern by the GOB about the impact on inflation in 2008-09, and significantly less pressure for the producers to get cash. (Note: during the December 17 auction, the contracts beginning in 2005 were effective January 1, meaning a near immediate cash-inflow. End Note.) Putting a positive, but ironic, spin on the auction's near-collapse, Batista argued it meant that the energy producers were not yet willing to accept "unrealistically low" prices.

¶8. (SBU) Sao Paulo EconOff spoke with a senior executive of an international energy generating firm, who said many energy-generating companies, including his own, were unwilling to sell at the artificially depressed price the GOB had set. The executive said his firm has been telling the GOB for years that the GOB's attempt to manage the market by segregating energy into old, interim, and new, is a "disastrous" approach. He lamented the auction's lack of transparency. While suggesting "it's anybody's guess" as to how the GOB should proceed, the source said that for the energy sector, which requires long-term investment, the lack of transparency and GOB interference in the market sends "the worst kind of signal." In his opinion, considering the current environment, no private energy company will wish to make new investments in Brazil. He surmised the GOB may soon have to depend on its own funds to finance energy supply and related infrastructure projects. Another executive expressed concern about the GOB or parastatals leading investment into new energy projects because of their fundamentally different perspectives about business operations; he also considered additional investments into the country less likely if the GOB continues to diminish the value of the product.

FEAR AND LOATHING

¶9. (SBU) In particular, private generators and industry analysts object to the differentiation between "old" and "new" energy as creating artificial price differences for the same product. An executive of a private energy generation company told Brasilia EconOff that with multiple rounds of auctions for the same product, the GOB may be setting itself up for potential lawsuits by companies who sold energy at one (lower) price during an early auction, while another company is selling at another (higher) price at a subsequent auction. Eric Westberg, a former president of APINE who now represents a private investment firm, expressed surprise to Brasilia and Rio EconOffs that the energy model had not generated any lawsuits yet, but assumed this was

because the state-owned generators dominated the first auction and were less likely to sue the GOB.

COMMENT: "NEW" WINE IN "OLD" BOTTLES?

¶10. (SBU) Although the Lula administration generally has pursued market-oriented and orthodox macroeconomic policies, its energy model creates a system in which the State plays a leading role in a mixed private-public energy sector. The lack of transparency and apparent GOB manipulation of the auction rules to achieve stable, incremental growth in electric energy prices, however, has added to widespread doubts about the system and is having a negative impact on the investment climate. The likely delay of the new energy auction until the November time-frame is bad news, as the GOB needs to get licensing and construction of new hydroelectric plants started as soon as possible in order to meet expected energy capacity needs beginning in 2009. And, while the GOB model arguably will provide more stability for new concession holders than they have chosen to give to existing energy producers, the desire by GOB policymakers to reject what they view as "unbridled" market forces is clear. As many details of the auctions for new energy remain to be worked out, there is still time for the GOB to adjust to a more open, market approach. If this is to indeed happen, pressure from private power producers will be key.

¶11. (U) This cable reflects input from Consulates General Sao Paulo and Rio de Janeiro.

CHICOLA